

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 16th Floor
Sacramento, California 95814

REG-2007-00049

September 14, 2007

INITIAL STATEMENT OF REASONS

California Insurance Commissioner Steve Poizner will consider amendment of Title 10, Chapter 5, Subchapter 7.7, Sections 2697.6 and 2697.61 of the California Code of Regulations (10 CCR §§2697.6 and 2697.61).

SPECIFIC PURPOSE OF THE REGULATION

The proposed regulations will allow the CEA to combine its separately financed base-limits and optional-limits programs.

NECESSITY

The California Earthquake Authority ("CEA") writes earthquake insurance. It was established by the Legislature in response to the widespread unavailability of homeowners and earthquake insurance after the 1994 Northridge earthquake. The CEA carefully considers the purpose of its formation when shaping its fundamental objectives, one of which is increasing the availability of earthquake insurance for California renters, condominium owners, and homeowners. As a public instrumentality of the state, the CEA is governed by a board of elected state officials and managed by a staff of primarily civil servants; the CEA is funded largely with private monies.

The CEA enabling statute authorizes the CEA to write basic residential earthquake insurance and, by regulation, the basic product has been divided into a "base" product (the CEA's statutory "mini-policy," "base program," or "base limits policy") and an "optional-limits" product, usually called the CEA's Supplemental Limits Program. However, as they were initially enacted, the regulations also required the financing of the "optional limits" program to be strictly separated from the "base-limits" program.

Upon creation of the optional limits program, the CEA obtained quota share reinsurance and financial guaranty insurance (since dropped) to support it. However, as of 2006, quota share reinsurance became unavailable to the CEA. As a result, the CEA switched its supplemental limits reinsurance to a costly excess-of-loss reinsurance program, which exhausted all capital attributable to and available for the supplemental limits program. In response, the CEA obtained additional reinsurance financing, in part, from the proceeds of CEA revenue bonds issued in July 2006. In addition, the CEA applied for and received approval from the Department of Insurance for a rate increase in its optional limits coverages and also, through amended regulations, temporarily transferred funds from the base limits program to the supplemental program. In 2007, due to revisions in projections that revealed a likelihood of an additional shortfall in money available to pay supplemental limits program expenses, the CEA made further temporary

transfers of funds from the base limits program. Currently, the CEA's continuing ability to access the reinsurance market remains good for the base limits program. However, it continues to be constrained for the supplemental limits program, requiring the CEA to anticipate additional fund transfers. This continuing problem with supplemental limits reinsurance financing casts doubt upon the CEA's ability to maintain the program as a separate program.

The CEA believes that while the base limits policy is quite helpful and would cover, for example, a house and a small amount of personal property and living expenses, it has really been the Supplemental Limits Program that has driven CEA success in policy sales for several years. The CEA sees the Supplemental Limits Program as key to its ability to increase the availability of earthquake insurance for Californians.

CEA staff has determined that the best way to maintain the availability of the Supplemental Limits program is to integrate the coverages available under the base limits and optional limits programs and eliminate the regulatory requirement for separate financing of the two programs. It also believes that sound financial reasons exist for combining the base and supplemental limits program into one financial structure. The proposed regulations would allow the CEA to do so.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDY, REPORTS, OR DOCUMENTS

The Commissioner did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing the adoption and amendment of these regulations.

REASONABLE ALTERNATIVES TO THE REGULATION AND THE AGENCY'S REASONS FOR REJECTING THOSE ALTERNATIVES

No other alternatives to the regulation (including alternatives to lessen any adverse impact on small business) were presented to or considered by the Commissioner. The Commissioner has determined that the proposed amendment will only affect insurance companies and will therefore not affect or impact small business. Pursuant to Government Code section 11342.610(b)(2), insurers are not small businesses. All reinsurers are necessarily insurers.

EVIDENCE SUPPORTING FINDING OF NO SIGNIFICANT ADVERSE ECONOMIC IMPACT ON ANY BUSINESS

The Commissioner has made an initial determination that adoption of the proposed amendment will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.